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No. 98-1967

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1998

F. W. WOOLWORTH CO. and
KINNEY SHOE CORPORATION, *Petitioners*,

v.

FRANCHISE TAX BOARD, *Respondent*.

ON PETITION FOR WRIT OF CERTIORARI TO THE
COURT OF APPEAL OF CALIFORNIA

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

BILL LOCKYER
Attorney General
TIMOTHY G. LADDISH
Senior Assistant Attorney General
RANDALL P. BORCHERDING
Supervising Deputy Attorney General
JOYCE E. HEE
Deputy Attorney General
Counsel of Record
1515 Clay Street, 20th Floor
Oakland, California 94612-1413
Telephone: (510) 622-2227
Fax No: (510) 622 2121
Counsel for Respondent

33pp

QUESTION PRESENTED

Petitioners challenge the constitutionality of what is referred to as the "interest offset" provision contained in section 24344(b) of the California Revenue and Taxation Code.[1/] The questions presented are as follows:

> (1) Does the limitation of Woolworth's business interest expense deduction by the amount of its nonbusiness dividend income derived from Woolworth's non-unitary foreign subsidiaries pursuant to Section 24344(b) mean that that dividend income is being indirectly taxed by California in violation of the Due Process Clause of the United States Constitution, or does this interest offset provision represent a reasonable means to apportion a multi-state business's interest expense between sources within California and without the state in accordance with established unitary business principles and to avoid a tax loophole?
>
> (2) Does application of the interest offset provision of Section 24344(b) violate the Commerce Clause of the United States Constitution?
>
> (3) Does application of the interest offset provision of section 24344(b) violate the Equal Protection Clause of the United States Constitution?

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1. All future section references are to the California Revenue and Taxation Code unless otherwise indicated.

PARTIES IN THE COURT BELOW AND RULE 29.6 LIST

Respondent accepts the Petitioners' statements in this regard.

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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondent Franchise Tax Board of the State of California respectfully submits this brief in opposition to the petition for writ of certiorari.

OPINIONS BELOW

The relevant appellate opinion and related judgment and orders are contained in Petitioners' Appendix.

STATEMENT OF THE CASE

This is a tax refund case wherein Petitioners challenge the constitutionality of a tax statute referred to as the "interest offset" provision which applies to a corporation engaged in a unitary business. California imposes a franchise tax on every corporation doing business within the state. (Cal. Rev. & Tax. Code § 23151.) A corporation is taxed in this state only on the basis of its income from California sources. Thus, the measure of tax is a corporation's net income derived from or attributable to sources within the state. (Cal. Rev. & Tax. Code § 25101.)

Net income derived from or attributable to sources within California is determined on the basis of unitary business principles. (See *F. W. Woolworth Co.* v. *Taxation and Revenue Department*, 458 U.S. 354 (1982); *Butler Brothers* v. *McColgan*, 17 Cal.2d 664, 111 P.2d 334 (1941), aff'd. 315 U.S. 501 (1942); *Edison California Stores* v. *McColgan*, 30 Cal.2d 472, 183 P.2d 16 (1947).) Unitary business principles describe a method of taxation whereby a business conducted by related taxpayers as a single economic enterprise and which earns income both within and without

California is treated as one unit for determining income attributable to the State. (*Container Corp.* v. *Franchise Tax Bd.*, 463 U.S. 159 (1983); *Tenneco West, Inc.* v. *Franchise Tax Bd.*, 234 Cal.App.3d 1510, 1518-1519, 286 Cal.Rptr. 354, 356-357 (1991).) Where a corporation is engaged in a unitary, and not a separate, business with other corporations comprising the parent and its subsidiary corporations, income is apportioned to California by reference to the total combined business net income of the entire unitary group.

That portion of a taxpayer's business income which has a California source is determined by applying an apportionment formula as outlined in the Uniform Division of Income for Tax Purposes Act ("UDITPA") (Cal. Rev. & Tax. Code §§ 25120-25139). The combined income of the unitary members is apportioned by the application of three factors -- sales, payroll and property -- which are averaged to arrive at an apportionment factor, which is then applied to the business income of the unitary group. (Cal. Rev. & Tax. Code § 25128.)

The apportionable income of a taxpayer does not include any of the dividend income that is nonbusiness income that the taxpayer receives. (Cal. Rev. & Tax. Code §§ 25121-25128). "The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities -- even on a proportional basis -- unless there is a '"minimal connection" or "nexus" between the interstate activities and the taxing State, and "a rational relationship between the income attributed to the State the intrastate values of the enterprise."'" (*Container*, *supra*, 463 U.S. at pp. 165-166, quoting *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 219-220 (1980), quoting *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 437 (1980); *Allied Signal Inc.* v. *Director, Div. of Taxation*, 504 U.S. 768, 772, 777-78 (1982).) In this case the taxpayer received dividend income which is nonbusiness income.

A. The Interest Offset Provision - Section 24344(b).

The California Court of Appeal succinctly and accurately summarized the application of California's interest offset provision (Section 24344(b)), as follows.

> "In calculating the corporate franchise tax, California follows the Uniform Division of Income for Tax Purposes Act (UDITPA) (Cal. Rev. & Tax. Code] § 25120 et seq.), which makes a distinction between business and nonbusiness income. [fn. omitted.] Business income is generally calculated by applying an apportionment formula based on sales, property and payroll to the corporation's unitary business income. ([Cal. Rev. & Tax. Code] § 25128.) Nonbusiness dividend income is not apportioned, but it is taxable by the corporation's state of domicile. ([Cal. Rev. & Tax. Code] §§ 25123, 25126.)
>
> In calculating taxable net income under the apportionment approach, section 24344 provides for the deduction of interest expense, subject to certain limitations. Under subsection (b), interest expense is fully deductible to the extent of business interest income. Additional interest expense is then offset against nonbusiness interest and dividend income (which is not subject to allocation by formula), with the remaining interest deductible. Applying this section, the [Franchise Tax] Board disallowed [petitioner Woolworth's] interest expense deduction on a dollar-for-dollar basis to the extent it received dividends from its nonunitary subsidiaries." (Appendix A: Opinion of

California Court of Appeal ["Op."] at pp. 14-15.)[2/]

The "interest offset" set forth in section 24344(b) follows the basic tenet of tax law that a taxpayer may not receive a deduction for expenses which are attributable to income which is not subject to tax. As explained by the California Supreme Court in *Pacific Telephone & Telegraph Co. v. Franchise Tax Board*, 7 Cal.3d 544, 555, 498 P.2d 1030 (1972), because California only imposes a tax on income that is attributable to sources within this state, where a corporation is engaged in activities within and without California, expenses must also be assigned to sources within this state and to sources without this state. (Cal. Rev. & Tax. Code § 25101.) If this were not done, a taxpayer would receive a deduction for all of its expenses even though all of its income was not being taxed by California, and even though a portion of those expenses was attributable to the income not being taxed. Interest expense must be assigned to prevent corporations from creating "a deduction for the interest expense without the offsetting income". (*Pacific Telephone*, *supra*, 7 Cal.3d at p. 554, 498 P.2d at p. 1037.)

Section 24344(b) provides for a method of assigning interest expense between income which is "subject to apportionment by formula" (i.e. income which is considered in the base used to determine the income upon which California tax is assessed), and income not "subject to apportionment by formula". Under section 24344(b), interest expense is deductible to the extent of business interest income (i.e. interest income which is subject to apportionment by formula). Due to the inherent imprecision in assigning interest expenses between business and

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2. "Op." means the opinion rendered by First Appellate District Court of Appeal, Division Three, in this case. (See Petitioners' Appendix A-1.)

nonbusiness sources, however, the remaining interest expense is then "offset" by the amount of interest and dividend income not subject to apportionment by formula. Any additional interest expense remaining after the application of the interest offset provision is deductible in determining net business income.

B. Application Of The Interest Offset Provision To Woolworth.

Petitioner F.W. Woolworth was incorporated in New York and maintained its principal place of business there. F.W. Woolworth Co. conducted business in numerous states, including California, and had many domestic and foreign subsidiaries.

In the lower courts, F.W. Woolworth Co. contended that it was engaged in a unitary business with its wholly owned subsidiary, Kinney Shoe Corporation. Respondent prevailed against Petitioners Woolworth and Kinney on this issue at trial, and the appellate court upheld the lower court's decision that Woolworth and Kinney did not constitute a unitary business during the years at issue. Petitioners did not raise the unitary issue in their petition for review in the California Supreme Court and therefore have conceded this issue.

The sole issue before this Court is the constitutionality of Section 24344(b). It is undisputed by the parties that Woolworth's foreign subsidiaries were not part of its unitary business. Therefore, the dividends Woolworth received from its nonunitary foreign subsidiaries constituted nonbusiness dividend income that is immune from taxation by California but which is subject to tax in New York, Woolworth's state of domicile. (Cal. Rev. & Tax. Code §§ 25123, 25126.)

Respondent Franchise Tax Board employed the constitutionally validated three-factor apportionment approach to calculate Woolworth's taxable net income. In doing so, Respondent applied the interest offset provision of Section 24344(b) as follows. For each year at issue, Woolworth's interest expense first was treated as fully deductible to the extent of its business interest income. To the extent that Woolworth had any additional interest expense, the deduction for such interest expense was then offset against, or reduced by, the nonbusiness dividend income it received from its non-unitary foreign subsidiaries. Any interest expense remaining after the application of the interest offset provision was treated as fully deductible.

REASONS FOR DENYING THE WRIT

I. The Issues In This Case Do Not Warrant This Court's Review.

This Court should deny the petition for writ of certiorari because the issues raised are not of sufficient importance to warrant this Court's review. The Court of Appeal declined to publish its opinion in this case, the California Supreme Court denied review, and the issues raised herein lack national import or significance.[3/] Thus, this case does not

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3. California Rules of Court, Rule 977 provides:

"Rule 977. (a) An opinion of a Court of Appeal or an appellate department of the superior court that is not certified for publication or ordered published shall not be cited or relied on by a court or a party in any other action or proceeding except as provided in subdivision (b).

(b) Such an opinion may be cited or relied on:

(1) when the opinion is relevant under the doctrines of law of the case, res judicata, or collateral estoppel; or

warrant the extraordinary exercise of discretion by this Court and the petition should be denied.

In support of their constitutional challenges to California's interest offset provision, Petitioners ask this Court to place Section 24344(b) under a microscope where the narrow focus distorts its purpose and effect and obfuscates its true function within the overall context of California's apportionment scheme under UDITPA.

In short, it is well settled in tax law that a taxpayer is not entitled to a deduction for expenses that are attributable to income which is not subject to tax. California may only tax income that is attributable to sources within the state. Where a corporation conducts business both within and without California, both the corporation's income and expenses must be assigned to sources within the state and to sources without the state in order to properly calculate the corporation's taxable net income. Analyzed within the overall context of California's apportionment scheme, Section 24344(b) is simply one reasonable means to apportion a multi-state business's interest expense between sources within the state and without the state in accordance with accepted unitary business principles and to avoid a tax loophole.

As will be demonstrated *infra*, section 24344(b) is not a machiavellian vehicle for discriminating against nondomiciliary corporations in favor of corporations domiciled in California as Petitioners would have this Court believe. The objective and function of California's interest

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(2) when the opinion is relevant to a criminal or disciplinary action or proceeding because it states reasons for a decision affecting the same defendant or respondent in another such action or proceeding."

offset provision are based upon apportionment principles previously affirmed by this Court. Applying those standards, the limitation of Woolworth's interest expense deduction by the amount of its nonunitary dividend income does not mean that California is taxing this income.

II. The Court of Appeal Decision Upholding Section 24344(b) Is Correct.

A. The Limitation On Woolworth's Interest Expense Deduction Pursuant To Section 24344(b) Does Not Result In Either Direct Or Indirect Taxation Of Constitutionally Immune Dividend Income In Violation Of The Due Process Clause Of The United States Constitution.

Petitioners contend that Section 24344(b)'s limitation of their tax deduction for interest expense in the dollar-for-dollar amount of the nonbusiness dividend income Woolworth received from its nonunitary foreign subsidiaries results in the taxation of that constitutionally immune income. According to Petitioners' analysis, consideration of this nonbusiness dividend income in calculating apportionable income, irrespective of the purpose of such consideration, would mean that California is taxing the income in violation of the Due Process Clause. This is not the case.

Section 24344 is premised on the idea that a state bears no obligation to allow a deduction for an expense relating to dividend income which that state is barred from taxing. The interest offset rule is an ordering rule for the deduction of interest expense and constitutes a legislative attempt to assign a proper income source to interest expense, such that only interest expense which is properly attributable to business

activities is available as a deduction against business income.

Given the fungible nature of money, however, it is virtually impossible to trace borrowed funds to determine whether interest expense was incurred for business or nonbusiness (investment) purposes. Money which a corporation ostensibly borrows to finance its business operations can easily be converted to finance, either directly or indirectly, nonbusiness investment activities. Moreover, even when borrowed funds are in fact used for business purposes, the mere act of borrowing will generally make available other funds which the corporation can utilize for nonbusiness purposes. Thus, the interest offset rule, as explained by the California Supreme Court in *Pacific Telephone*, *supra* (see discussion below), constitutes a rational legislative assignment of interest expenses to business or nonbusiness sources, thereby preventing a corporation from obtaining a tax deduction for an interest expense attributable to income immune from California taxation.

In holding that the application of Section 24344(b) does not result in the indirect taxation of constitutionally immune income, the Court of Appeal relied upon the California Supreme Court's analysis in *Pacific Telephone*, *supra, 7 Cal.3d 544; 498 P.2d 1030.* Respondent believes that that analysis is accurate and in keeping with fundamental apportionment principles that have been repeatedly affirmed by this Court.

In *Pacific Telephone*, the taxpayer contended that the limitation on deductible interest expense imposed by section 24344 should only apply to taxable dividend income and not to nontaxable dividend income allocated outside of California. The California Supreme Court rejected such a reading of section 24344 on the following grounds.

First, the statute does not refer to "taxable income," but rather to "interest and dividend income . . . not subject to allocation by formula." (*Pacific Telephone*, *supra*, 7 Cal.3d at p. 553, 498 P.2d at p. 1037.) Second, nontaxable dividends (dividends not allocated to California) fall within the logic of the interest offset provision, which is to offset interest expense to the extent possible against investment income. (*Pacific Telephone*, *supra*, 7 Cal.2d at p. 554, 498 P.2d at p. 1037.)

The California Supreme Court stated at 7 Cal.2d at pages 551-552, 498 P.2d at p. 1036:

> "In treating interest expense as the opposite of investment income (interest and dividend income), the subsection is obviously approaching the problem presented in a reasonable manner. Interest expense is the opposite of interest income, and dividend income is sufficiently analogous to interest income that it is reasonable to provide for the offset of interest expense against dividend income."

Nontaxable dividends thus qualify as investment income within the meaning of Section 24344.

Third, a reading of the interest offset provision which takes into account only taxable income, but not nontaxable dividends, would create a "loophole" for taxpayers. The California Supreme Court explained:

> "A foreign corporation could avoid all taxes in California merely by increasing its borrowing to create an interest deduction and then purchasing stocks which pay dividends. Since under the principle of *mobilia sequuntur personam*, the dividends will not be taxed, the corporation would

> have created a deduction for the interest expense without the offsetting income. **To avoid the loophole, the deduction must be reduced by the income even though the income cannot be taxed in California.**" [Fn. omitted; emphasis added.] (*Pacific Telephone*, *supra*, 7 Cal.2d at p. 554, 498 P.2d at p. 1037.)[4/]

Fourth, the phraseology of section 24344 suggests that the statute was intended to "act as a limitation on the amount of interest expense." (*Ibid.*) The California Supreme Court then proceeded to specifically hold that dividends are to be included in the calculation of interest offset under section 24344 regardless of whether they are taxable or not.

> "Inclusion of nontaxable dividends in the [section 24344] subsection (b) computation does not mean that California is taxing dividends of a foreign corporation . . . . The dividends are not being taxed. They are being used to offset or reduce the interest expense deduction, and, as pointed out above, it is not unreasonable to use investment income to offset investment expense.
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> . . .
>
> "[¶] . . . **The apportionment of expenses to offset income from sources without the state does not mean that the out-of-state income is being taxed so long as it is not unreasonable to use the expense to offset the out-of-state income. California uses two methods to apportion the income, one for operating income and another for dividend income, and it is not unreasonable**

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4. Since *Pacific Tel.*, the doctrine of *mobilia sequuntur personam* has been replaced by the business/nonbusiness distinction under UDIPTA. However, under both doctrines, the allocation of the dividend income here at issue to a source outside of California remains the same.

> **to view interest expense as investment expense and require that the interest expense be used to offset the investment income, the interest and dividend income. This is true whether or not the investment income is included in the measure of the California tax. Accordingly, the requirement that dividend income, whether or not included in the measure of the tax, be used to offset or reduce the interest expense deduction does not mean that the dividend income is being taxed."** [Emphasis added.] (*Pacific Telephone*, *supra*, 7 Cal.3d at p. 555, 498 P.2d at p. 1038.)

Petitioners assert that the California Supreme Court's analysis in *Pacific Telephone* is simply "California's attempt to relabel what in reality is unconstitutional taxation." (Petition, p. 15.) In fact, this analysis reflects the fundamental apportionment principle that a statute that merely apportions deductions by the measure of nontaxable income imposes neither a direct nor indirect tax on such tax exempt income. This principle has been affirmed by this Court in a number of cases. These cases essentially hold that a statute that merely correlates expenses between taxable income and nontaxable income in order to determine the allowable deduction for the purpose of determining taxable income does not result in the imposition of an impermissible tax on nontaxable income.

In *Denman v. Slayton*, 282 U.S. 514 (1931), this Court upheld the constitutionality of a federal tax statute which permitted the deduction from taxable income of interest expense on indebtedness, except as to indebtedness incurred to purchase or carry tax-exempt securities. The Court concluded that the disallowance of deduction from taxable income of interest expense on indebtedness incurred to purchase or carry tax-exempt securities did not result in the impermissible taxation of tax-exempt income.

Similarly, in *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371 (1934), this Court upheld the constitutionality of federal tax provisions which allowed the deduction of depreciation and expenses of buildings owned by life insurance companies but only on the condition that the company include in its gross income the otherwise nontaxable rental value of the space which it occupied. The Court ruled that the statutory provisions did not amount to an improper tax on the tax-exempt rental value, but were simply a permissible "apportionment of expenses." (*Id.*, at p. 381.)

In *United States v. Atlas Life Ins. Co.*, 381 U.S. 233 (1965), this Court "affirm[ed] the principle announced in *Denman* and Independent Life that the tax laws may require tax-exempt income to pay its way" by upholding the pro rata deduction provisions of the Life Insurance Company Income Tax Act of 1959. Under a formula prescribed by these provisions, the taxable investment income of a company was divided between the policyholders' share, which was not taxed, and the company's share, which was taxed, and the company was permitted to deduct only its share of tax-exempt interest from gross income. The United States Supreme Court rejected the insurance company's contention that this allocation resulted in an impermissible tax on its tax-exempt municipal bond interest and that it should be permitted to deduct the full amount of its exempt interest.

In *First Nat. Bank v. Bartow Cty. Tax Assrs.*, 470 U.S. 583 (1985), this Court dealt with a state statute which imposed a tax on the property of banks calculated on the basis of the bank's net worth. In calculating net worth, a bank was not permitted under the statute to deduct the full value of tax-exempt United States obligations which it held. The United States Supreme Court held that the provision of the state statute limiting the deduction did not violate the tax-

exempt status of federal obligations, confirming its earlier rulings in *Denman*, *Independent Life*, and *Atlas Life*.

As noted above, given the impossibility of precisely attributing borrowed funds to business or nonbusiness purposes, California's interest offset rule is a rational legislative method of assigning interest expenses to business and nonbusiness sources. This California rule is consistent with this Court's affirmation of the principle that tax-exempt income may be made to bear a fair share of the burdens properly allocable to it. (*United States* v. *Atlas Life Ins. Co.* and *Denman, supra.*)

B. The Purpose And Logic Of Section 24344(b), As Analyzed In Pacific Telephone, Remain Viable.

Petitioners argue that the interest offset statute cannot be sustained as "reasonable" because the tax loophole which the California Supreme Court indicated Section 24344(b) was meant to close does not exist as a matter of law. (Petition, pp. 17-18.) They maintain that the purported "logic" of the statute (*e.g.* that it is not unreasonable to assume a connection between interest expense and investment income) fails as a matter of law. As demonstrated below, these arguments are without merit.

According to petitioners' analysis, California's "interest offset applies only to *business* interest expense (*i.e.*, expense incurred in the regular course of the taxpayer's business, as opposed to expense incurred for investments)" so "as a matter of law, the interest expense involved in interest offset does not relate to or 'match' nonbusiness dividend or investment income." (Italics in original, Petition pp. 18-19.) Petitioners' analysis is incorrect because section 24344 refers to "interest expense" not "business interest expense".

Petitioners' erroneous analysis of California's interest offset provision is based upon an apparent ambiguity in Cal. Franchise Tax Return Form 100, Schedule R-5. (See Petition, p. 18.) Citing Cal. Franchise Tax Return Form 100, Petitioners contend that the interest offset calculation requires the exclusion of any "nonbusiness interest expense" as the first step in the interest offset calculation thus suggesting that the interest offset necessarily applies only to "business interest expense". This is **not** the case, because Section 24344(b) does not require the exclusion of any "nonbusiness interest expense" as the first step. Even if the tax form suggests otherwise, it is a non-issue. It is the statute that governs the proper calculation of interest offset, not the tax return form.

In any event, as a factual matter, the potential conflict between the calculation of interest offset using the methodology prescribed by Section 24344(b) and the calculation using Cal. Franchise Tax Return Form 100 was never at issue in this case.[5/] Petitioners have never argued that the interest offset provision was improperly calculated when they used the methodology prescribed by Section

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5. Another case involving essentially the same constitutional challenges to Section 24344(b) as those raised herein was heard by the same appellate panel, on the same day, as this case. That case is currently pending before this Court--*Hunt-Wesson, Inc. v. Franchise Tax Board*, U.S. Supreme Court No. 98 -2043, petition for writ of certiorari filed June 21, 1999). In *Hunt-Wesson*, the plaintiff specifically addressed the apparent ambiguity in Cal. Franchise Tax Return Form 100. As in this case, it was made clear to the appellate court that this was a non-issue because the parties agreed that the interest offset calculation was made in conformity with the requirements of Section 24344(b), not the tax return form, and that Section 24344(b) does not require exclusion of all "nonbusiness interest expense" as a first step. Respondent's opposition to the petition for writ of certiorari in *Hunt-Wesson* is due on August 21, 1999.

24344(b); rather they challenge the constitutionality of that methodology.

Because Section 24344(b) does not require the initial exclusion of "nonbusiness interest expense" from the interest offset computation, Petitioners' argument that as a matter of law, the interest expense involved in interest offset does not relate to or match nonbusiness dividend or investment income fails. In fact, because money remains fungible, the purpose and logic of the application of interest offset to nontaxable dividend income in order to close a potential tax loophole, as explained in *Pacific Telephone*, remains viable.

Petitioners further argue that the interest offset statute is not reasonable and contravenes the Due Process Clause because it makes no attempt to match dividend income against the interest expense incurred to produce the income. (Petition, p. 19.) Petitioners point to the fact that "some states allocate interest expense 'attributable' to nontaxable dividend income according to an apportionment formula, usually based on the ratio of nonbusiness income to total income or the ratio of nonbusiness assets to total assets." (Petition, pp. 19-20, fn. 11.)

California's interest offset statute does not require nor provide for, tracing of borrowed funds to determine whether interest expense was incurred for business or nonbusiness (investment) purposes. Given the fungible nature of money, such tracing would be administratively overburdensome and would not necessarily result in an accurate match of dividend income against interest expense incurred to produce that income.

This dilemma is part of a tax administrator's difficult task of measuring the appropriate amount of unitary business

income attributable to those members of a unitary group subject to tax in the State. As this Court has observed,

> "Allocating income among various taxing jurisdictions bears some resemblance, . . . to slicing a shadow." (*Container, supra*, 463 U.S. at p. 192.)

There is no exact, scientific way of apportioning a multi-state unitary business's interest expense between sources within California and sources without the state. Section 24344 provides a rational legislative solution to the serious administrative difficulties which Respondent would encounter if it were required to attempt to ascertain the precise purpose for which a taxpayer's interest expense was incurred. Clearly the proceeds of the loans which generated Woolworth's interest expense deductions inevitably supported the activities of the Corporate Office which conducted activities relating to both its unitary and nonunitary subsidiaries. The funds invested in the nonunitary subsidiaries in earlier years was money which, if used for business purposes, would have reduced, if not eliminated, the need to borrow during the fiscal years.

Similarly, the borrowed funds inevitably had the effect of making available other working capital for F. W. Woolworth Co. to use, either now or in future years, for the direct or indirect benefit of its nonunitary subsidiaries. These nonunitary subsidiaries generated substantial dividend income which was allocated entirely outside of California. Petitioners seek to gain a full deduction for all its interest expense including that portion which was indirectly used to generate income not taxable to California. This double tax benefit is precisely the "loophole" which section 24344(b) was intended to eliminate, as recognized by this Court in *Pacific Telephone*.

In Section 24344, the Legislature has selected one method among several methods to assign interest expense between classes of income for the purpose of determining net income. Such assignment does not result in the indirect taxation of such income but rather results in the reasonable matching of expenses to income with the taxable nature of the income dictating the deductibility of the expense. The Court of Appeal was correct in finding that although there may be other reasonable methods of treating interest expense, California's approach is a reasonable one. (Op. at p. 17.).

C. The Interest Offset Provision Does Not Contravene The Commerce Clause.

Petitioners contend that Section 24344(b) "violates the Commerce Clause prohibitions on local economic protectionism by discriminating against interstate commerce." (Petition, p. 20.) First, petitioners assert that California's intent to discriminate is clear. They rely upon statements taken out of context from the *Pacific Telephone* decision as evidence of the State's purported discriminatory intent. (Petition, p. 21.).[6/] In fact, the record in this case is

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6. Petitioners assert that the following highlighted statement in the *Pacific Telephone* decision is clear evidence that in enacting Section 24344(b), California intended to favor domiciliary corporations and to discriminate against interstate commerce. The California Supreme Court stated:

> "A fourth reason, although perhaps not a strong one alone, for refusing to limit dividends to taxable dividends, is the phraseology of the section. It was pointed out above that as to a domiciliary corporation the subsection is not a limitation on interest expense but merely establishes a method to allocate the expense. Nevertheless the phraseology of the subsection is that of limitation, and this indicates that in some situations the subsection must act as a limitation on the

devoid of any substantial evidence to support Petitioner's contention in this regard.

Petitioners further assert that Section 24344(b) is facially discriminatory because it purportedly subjects nondomiciliary corporations involved in interstate commerce to higher tax burdens than California domiciled corporations and imposes higher tax burdens on recipients of dividend income from subsidiaries operating wholly outside California than recipients of dividend income from subsidiaries operating wholly within California. (Petition, p. 23.) Petitioners have distorted the focus of the constitutional analysis in order to frame the question to their advantage.

The pertinent focus is not the effect that interest offset has on domiciliary corporations versus nondomiciliary corporations, in isolation, but how a corporation's interest expense is attributable to business income and nonbusiness income within the overall apportioned tax scheme that is applied to a unitary business and whether there is internal

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amount of interest expense. **The limitation view is reinforced because of a letter to former Governor Knight by the board prior to his signing the legislation before us which states that the addition of the provision before us will increase taxes on foreign corporations while reducing those of domestic corporations.** [¶] Inclusion of nontaxable dividends in the subsection (b) computation does not mean California is taxing dividends of a foreign corporation contrary to the doctrine of *mobilia sequuntur personam*. The dividends are not being taxed. They are being used to offset or reduce the interest expense deduction, and, as pointed out above, it is not unreasonable to use investment income to offset investment expense." (7 Cal. 3d at p. 535; 498 P.2d at p. 1038)

This statement alone does not constitute evidence of legislative intent to discriminate. Neither the Board letter referred to above nor the legislative history of the interest offset provision is in evidence in this case.

consistency if that scheme were applied by every jurisdiction.

The Court of Appeal addressed petitioners' Commerce Clause arguments, as follows:

> "Appellants suggest the interest offset provision favors local commerce in two ways. First, they argue that subsidiaries' income from California sources does not attract interest offset because such earnings are 'previously taxed' and therefore deductible from the tax base under Section 24402. However, because California has previously taxed the income in question, we discern no unconstitutional discrimination in the state refraining from double taxation. (See *Pacific Telephone, supra*, 7 Cal.3d at p. 548, fn.4.) Unlike *Fulton* [*Corp.* v. *Faulkner* (1996) 516 U.S. 325], *supra*, on which appellants rely, the statute does not waive an otherwise uniform intangibles tax, based simply on the percentage of the underlying corporate income taxed by the state. Instead, it operates as part of an overall apportioned tax scheme, matching expenses with income in a manner which our Supreme Court has determined to be reasonable. (*Pacific Telephone, supra*, 7 Cal.3d at pp. 551-551, 555.) Second, appellants contend California corporations are favored because their interest expense is fully deductible against their subsidiaries' dividend income. [fn omitted.] Our Supreme Court recognized this anomaly in Pacific Telephone, but upheld the statute on the theory that the interest offset does not tax the offset dividend income. [fn. omitted.] (*Supra* at p. 555.)" (Op. at pp. 20-21.)

As the Court of Appeal accurately determined, Section 24344(b) does not provide for disparate treatment of interest expense depending upon whether the taxpayer is a domiciliary or nondomiciliary corporation. It is the character of the income (i.e., business or nonbusiness) attributable to a corporation's interest expense that determines whether a corporation may fully deduct its interest expense in California, not the corporation's state of domicile. Therefore, Section 24344(b) is not facially discriminatory against interstate commerce.[7/]

California law provides for a deduction of dividends declared from income which has been "included in the measure of the taxes imposed . . . upon the taxpayer declaring the dividends." (Cal. Rev. & Tax. Code § 24402.) This deduction is intended "to avoid double taxation at the corporate level of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation." (*Pacific Telephone*, *supra*, 7 Cal.3d at p. 548, fn. 4, quoting *Safeway Stores, Inc. v. Franchise Tax Board* 3 Cal.3d 745, 749-750 (1970); italics omitted.) Since the dividend-producing income has already been taxed in California, no advantage is afforded to California subsidiaries over foreign subsidiaries.

Because Section 24344(b) excludes from the operation of the interest offset any amount attributable to dividends which have been included in the measure of the taxpayer's

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7. Petitioners rely upon *Fulton Corp.* v. *Faulkner*, 516 U.S. 325 (1996) . As the Court of Appeal observed, *Fulton* is distinguishable because the intangibles tax in *Fulton* was facially discriminatory against interstate commerce where it permitted a taxable percentage deduction equal to the percentage of the issuing corporation's income taxed by the state. California's interest offset provision is not facially discriminatory and operates as part of an apportionment formula that matches expenses with income in a reasonable manner.

taxes, neither the California domiciled corporation nor the out-of-state domiciled corporation may take those dividends into account in the calculation of interest applied under the interest offset. Thus, any amount removed from the application of the interest offset attributable to such dividends is equally removed for both. Accordingly, California domiciled corporations are not treated differently with respect to such amounts, and are afforded no advantage related to their domicile. Thus, the Court of Appeal properly relied upon the reasoning and holding in *Pacific Telephone* in rejecting the appellants' constitutional challenges to Section 24344(b).

With respect to a Commerce Clause challenge, the interest offset provision is not to be tested in isolation but must be analyzed as part of an overall taxing scheme by which Woolworth's income is apportioned pursuant to a judicially-approved formula among all of the states in which it conducts business. This Court has declared that a taxing statute applied to a unitary business is constitutionally sound if it has "what might be called internal consistency" if applied by every jurisdiction. This doctrine has been applied to statutes challenged on the grounds of facial discrimination under the Commerce Clause. (*ARMCO, INC.* v. *Hardesty* 467 U.S. 638, 644 (1984); *Tyler Pipe Inds.* v. *Dept. of Revenue* 483 U.S. 232 (1987).)

Thus, the constitutionality of Section 24344(b) is not to be tested solely on the basis of its impact on F. W. Woolworth's California tax but upon its impact upon Woolworth's collective tax liability in all of the states in which it is subject to tax. The applicable test is, if Section 24344(b) were to be applied in every state in which Woolworth is taxable, does the statute result in no less than 100 percent of Woolworth's total interest expense being recognized as a deduction against its total tax liability? Applying the internal consistency doctrine to Section

24344(b) in this case, it is evident that if California's interest offset rule was applied by every state in which Woolworth was taxable, Woolworth would recognize the full benefit of a deduction for each dollar of interest expense which it had incurred.

To the extent that Woolworth's interest expense deduction was limited (offset) in California under Section 24344(b), that amount of offset interest expense will be recognized and have the effect of reducing Woolworth's taxable income in New York, its state of domicile. This is because the interest expense which is offset in California has essentially been statutorily deemed to be attributable to the generation of nonbusiness dividend income (nonbusiness income). The corporation's nonbusiness income is taxable in its state of domicile. (Cal. Rev. & Tax. Code § 25126.) In arriving at the amount of the corporation's nonbusiness income to be taxed the corporation will be permitted to deduct the interest expense attributed to the generation of that nonbusiness income (i.e. the amount of interest expense offset in California).

In the absence of distinctive issues, the anti-discrimination principle of the Commerce Clause "has not in practice required much in addition to the requirement of fair apportionment." (*Container*, *supra*, 463 U.S. at pp. 169, 171; see *Trinova Corp. v. Michigan Treasury Dept.* 498 U.S. 358, 384-387 (1989).) That the precision by which income is apportioned to each state may be somewhat imperfect does not alone violate the Commerce Clause. (*Amerada Hess v. Director, N.J. Dept. of Treasury* 490 U.S. 66, 74 (1989).) Petitioners have failed to establish that California's tax has not been fairly apportioned.

D. The Interest Offset Provision Does Not Contravene The Equal Protection Clause.

Petitioners' Equal Protection challenge to Section 24344(b) is based upon the same skewed focus upon corporate domicile that they rely upon for their Commerce Clause arguments. As discussed above, California's interest offset provision does not treat corporations unequally solely on the basis of their state of incorporation. Multi-state corporations engaged in a unitary business, whether domiciled in California or elsewhere, are subject to the same rules for offsetting interest expense against investment income.

"[I]n taxation, even more than in other fields, legislatures possess the greatest freedom in classification." (*Madden v. Kentucky*, 309 U.S. 83, 88 (1940).) Even if discriminatory, a classification is not violative of the Equal Protection Clause if any state of facts reasonably can be conceived that would sustain it. (*Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522, 528 (1959); *Western & Southern Life Ins. Co. v. State Board of Equalization*, 451 U.S. 648, 674 (1981); *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 464 (1981).) The validity of a statute has consistently been reviewed based on whatever may reasonably have been the legislative purpose and policy in adopting it. (*Allied Stores of Ohio*, *supra*, 358 U.S. at pp. 528-529.)

Section 24344(b) is rationally related to a legitimate state interest which is to close a potential tax loophole as discussed above. There is no single, scientific method of apportioning a multi-state unitary business's interest expense between sources within California and sources without the state. Section 24344 is a rational legislative solution to accomplish a legitimate objective. Clearly F.W.

Woolworth's nonunitary foreign subsidiaries generated substantial dividend income which was allocated entirely outside of California. In the absence of the interest offset provision, Petitioners would gain a full deduction for interest expense that was used to generate income not taxable to California. Section 24344(b) does not contravene the Equal Protection Clause of the United States Constitution.

CONCLUSION

Accordingly, Respondent respectfully submits that the petition for writ of certiorari should be denied.

Respectfully submitted,

BILL LOCKYER
Attorney General
TIMOTHY G. LADDISH
Senior Assistant Attorney General
RANDALL P. BORCHERDING
Supervising Deputy Attorney General
JOYCE E. HEE
Deputy Attorney General
Counsel of Record
1515 Clay Street, 20th Floor
Oakland, California 94612-1413
Telephone: (510) 622-2227
Fax No: (510) 622-2121
Counsel for Respondent

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